2015 Spending Affordability Committee Report and Recommendations to the Governor and the Legislative Policy Committee

The Spending Affordability Committee was created in 1982 (Chapter 585). The committee is composed of equal numbers of senators and delegates and includes the Presiding Officers, the majority and minority leaders, the chairmen of the fiscal committees (or their designees), and other members appointed by the Presiding Officers. A citizen advisory committee assists the committee.

The committee's primary responsibility is to recommend to the Governor and the General Assembly a level of spending for the State operating budget that is reflective of the current and prospective condition of the State's economy. Efforts to close the structural budget gap have been the focus of the committee's recommendations in recent years. For the first time since fiscal 2006, the general fund budget is estimated to be structurally balanced in the current year and the next two fiscal years. The committee's prior recommendations and legislative action on the operating budget are reflected in the table on the following page.

The committee notes that operating spending in relation to the State's economy, as measured by the personal income statistic, has fluctuated between 6.7% and 7.6%. The unprecedented increases under the Bridge to Excellence in Public Schools Act raised spending as a percentage of income during the period of 2004 to 2008. By 2009, the ratio reached 7.5%, the highest level since 1991, in part, due to falling income. Conversely, rising income and reduced State spending caused the ratio to drop to 7.2% in 2010; the rate has fluctuated between 7.3% and 7.5% since.

The committee's statutory responsibility is to consider spending in relation to the State's economy. In its review of the State's economy, the committee considered income and wealth factors in developing a broad understanding of Maryland's economic position. In determining the spending recommendation, the committee has considered economic performance, revenue estimates, and budget requirements.

Prior Recommendations and Legislative Action on the Operating Budget

($ in Millions)

	Committee Recommendation		Legislative Action	
Session Year	**Growth Rate**	**Amount**	**Growth Rate**	**Amount**
1983	9.00%	$428.0	5.70%	$269.8
1984	6.15%	326.7	8.38%	402.0
1985	8.00%	407.2	7.93%	404.6
1986	7.70%	421.5	7.31%	402.2
1987	7.28%	430.2	7.27%	429.9
1988	8.58%	557.5	8.54%	552.9
1989	8.79%	618.9	8.78%	618.2
1990	9.00%	691.6	8.98%	689.7
1991	5.14%	421.8	5.00%	410.0
1992	No recommendation		10.00%	823.3
1993	2.50%	216.7	2.48%	215.0
1994	5.00%	443.2	5.00%	443.2
1995	4.50%	420.1	4.50%	420.0
1996	4.25%	415.0	3.82%	372.8
1997	4.15%	419.6	4.00%	404.6
1998	4.90%	514.9	4.82%	506.6
1999	5.90%	648.8	5.82%	640.6
2000[1]	6.90%	803.0	6.87%	800.0
2001[2]	6.95%	885.3	6.94%	884.6
2002	3.95%	543.2	3.40%	468.1
2003	2.50%	358.2	0.94%	134.1
2004	4.37%	635.2	4.33%	629.0
2005[3]	6.70%	1,037.1	6.69%	1,036.3
2006[3]	9.60%	1,604.7	9.57%	1,599.0
2007	7.90%	1,450.0	7.51%	1,378.4
2008	4.27%	848.7	4.16%	826.8
2009[4]	0.70%	145.7	0.19%	39.2
2010[4]	0.00%	0.0	-3.00%	-626.9
2011	Reduce FY 2012 structural deficit by 33⅓%		36.90%/46.00%[5]	
2012	Reduce FY 2013 structural deficit by 50.0%		50.60%	
2013	Reduce FY 2014 structural deficit by $200.0 million			-211.2
2014	4.00%	937.8	2.76%	646.4
	Reduce FY 2015 structural deficit by $125.0 million			-126.1
2015	Reduce FY 2016 structural deficit by 50.0%		68.27%	

[1]2000 legislative action does not reflect $266.0 million of Cigarette Restitution Fund (CRF) appropriations. CRF dollars were excluded because it had not previously been available to the State. The 2000 growth rate, including CRF dollars, was 9.16%.

[2]Methodology revised effective with the 2001 session.

[3]The committee initially approved a limit of 5.70% for 2005 and 8.90% for 2006.

[4]Legislative action calculation includes federal funds under the American Recovery and Reinvestment Act of 2009 used in lieu of ongoing general fund spending.

[5]Spending reduction/total reduction.

Economy

While the 2007 to 2009 recession in Maryland was less severe than for the nation as a whole, it was still the worst economic contraction the State had experienced since the recession of the early 1990s. Recovery from the recession was derailed as the federal budget reductions of recent years along with the government shutdown in fall 2013 had a significant impact on Maryland's economy. The per capita inflation-adjusted gross State product fell in 2012 and 2013 for the first time since 2009 and growth was just 0.2% in 2014. The data available for 2015 shows significant improvement over the performance in 2014. Employment grew 1.4% in the first half of 2015 with private-sector employment up 1.8%. Total personal income was up 4.1% in the first six months of 2015.

In September, the Board of Revenue Estimates (BRE) issued a revised economic forecast for Maryland, its first since December 2014. BRE revisions aligned the economic outlook with recent performance. Employment growth for 2015 was revised up from 1.1% to 1.3%. The 2015 projection for personal income growth was increased from 3.8% to 4.3%. BRE lowered their assumptions for capital gains income from growth of 6.0% in 2015 to a decline of 10.0% reflecting the drop in the stock market in August. In December 2015, BRE further increased their estimate of 2015 employment growth to 1.5% in light of year-to-date performance but also lowered the estimate for wage growth from 4.2% to 3.9%. Given the rebound in the equity markets, BRE changed their estimate of 2015 capital gains income from a drop of 10.0% to no growth.

Revenues

Fiscal 2015 general fund revenues exceeded the estimate by $214.1 million. General fund revenues totaled $15.9 billion in fiscal 2015, an increase of 5.4% over fiscal 2014. The biggest source of overattainment was the personal income tax. General fund personal income tax revenues were over the estimate by $178.0 million and grew 7.4% over fiscal 2014.

Fiscal 2016 general fund revenues through November are up 4.2% over fiscal 2015. In September, BRE raised their estimate for fiscal 2016 general fund revenues by $81.0 million. The personal income tax estimate was revised up by $107.0 million. In December, BRE increased the general fund estimate for fiscal 2016 by $31.4 million reflecting the revised economic assumptions and the year-to-date performance which includes some large estate tax payments. BRE's fiscal 2016 estimate also now includes an additional distribution of $45.0 million to the local income tax reserve account to work down the underfunding of the account. BRE increased their general fund revenue estimate for fiscal 2017 by $60.1 million. The fiscal 2017 estimate does not include an extra distribution to the local income tax reserve account.

Budget Requirements

Taking into consideration the revenue projections by BRE in December 2015, the committee is currently projecting an ending general fund balance of $561.2 million at the close of fiscal 2016. This projected surplus reflects anticipated spending shortfalls requiring fiscal 2016 general fund deficiency appropriations of $116.9 million. Major areas that are expected to require deficiency funding include the Developmental Disabilities Administration based on a recent federal audit disallowance of previously claimed federal funds; education foundation aid based on projected shortfalls in Education Trust Fund revenues; student assessment contracts; personnel and operating expenses in the Departments of Public Safety and Correctional Services and State Police; and the need to backfill for unattained 2% cost containment in various agencies. However, these deficiency requirements are more than offset by an anticipated $151.9 million general fund surplus in the Medicaid program driven by such factors as lower enrollment and higher special fund availability.

The baseline estimate for fiscal 2017 projects general fund growth of 6.7% when capital and reserve fund appropriations are included, resulting in an ending balance of $324.0 million. The general fund budget growth includes $307.5 million for entitlements, mandated formulas, and other statutory increases. For example, education aid formulas increase by $139.4 million, due primarily to a 1.0% increase in the per pupil foundation aid formula, the full funding of the Geographic Cost of Education Index, and an increase in compensatory aid, which is based on the foundation aid formula and the number of children eligible for free and reduced-price meals, which has also grown; the increase in general funds for debt service payments is $81.6 million; and Medicaid (including behavioral health) increases by an estimated $92.7 million to fund higher enrollment levels plus the assumption of modest rate increases for most providers.

In terms of State agency spending, the baseline assumes $495.5 million in general fund growth, $263.0 million of this increase is driven by personnel costs. The baseline assumes a 2% general salary increase for fiscal 2017 effective July 1, 2016, with a general fund cost of $75.9 million plus regular increment increases totaling $77.7 million. Health insurance costs increase by $57.2 million, and employee retirement costs grow by $27.3 million.

The committee projects that the State will close fiscal 2017 with a balance of $1,070.1 million in the Rainy Day Fund, which represents 6.3% of general fund revenues. The statutorily mandated appropriation for fiscal 2017 will be $235.3 million. It should be noted that the baseline assumes that the unappropriated general fund balance at the close of fiscal 2015 will result in a $50.0 million fiscal 2017 appropriation to the Dedicated Purpose Account to be subsequently transferred to the pension fund as provided for in the Budget Reconciliation and Financing Act of 2015.

Recommendations

In light of the considerations discussed earlier, the committee proposes the following recommendations for the 2016 session:

1. Operating Budget Spending Limit and Sustainability

The spending affordability process was put in place in 1982 with the goal of calibrating the growth in State spending to growth in the State's economy. In implementing that objective, a unique method of classifying and accounting for State spending was developed and has been periodically revised as circumstance has required. In recent years, the recommendation of the committee focused on closing the sizeable structural deficit that had been generated by extraordinary fiscal issues – plummeting revenues, substantial short-term federal assistance, and extensive reliance on one-time budget balancing actions. During those years, the traditional establishment of a growth limit was replaced with recommendations to reduce the structural deficit by a specified amount. This was a moving target because of the significant revenue write-downs at BRE each year that occurred after the passage of the budget by the General Assembly.

The committee's 2015 recommendation to reduce the structural deficit by 50% was the fifth consecutive year addressing the need to reduce the structural general fund gap. In the 2015 session, the spending affordability goal was exceeded as over 70% of the structural gap was resolved by the budget enacted by the General Assembly.

These efforts combined with favorable revenue projections have resulted in the elimination of the spending gap one year ahead of the schedule set last year and created a projected structural surplus for fiscal 2016 through 2018. This improvement in the State's budgetary outlook supports the transition to the more traditional method for maintaining spending affordability for the upcoming session. **As such, the committee recommends that the fiscal 2017 general fund budget maintain structural balance and that appropriations subject to the spending affordability limit shall be limited to growth of no greater than 4.85% over those approved at the 2015 session. This limit places growth in State spending in line with the average anticipated growth in personal income for calendar 2016 and 2017. This limit would provide for a $1,184 million increase in appropriations at the 2016 session, allowing for total expenditures subject to spending affordability of $25,601 million. This growth limit provides sufficient resources to support the full funding of mandated education costs and other mandated programs, as well as merit increases and cost-of-living adjustments for State employees.**

2. Fund Balances

The committee projects a Revenue Stabilization Account ("Rainy Day" Fund) balance at the end of fiscal 2016 of $813.8 million, which would maintain the balance at 5.0% of estimated fiscal 2016 general fund revenues. Fiscal 2015 closed with an unassigned general fund balance totaling $295.3 million. By law, the first $10.0 million remains in the general fund. The law also requires that an amount up to $50.0 million be applied to the unfunded employee pension liability. An amount equal to the remaining $235.3 million is required to be appropriated into the Rainy Day Fund. At the end of fiscal 2017, the Rainy Day Fund balance is projected to be $1,070.0 million, which is 6.3% of estimated general fund revenues. **The committee recommends that the balance in the Rainy Day Fund be maintained at or above $1 billion unless otherwise provided by an action of the General Assembly.**

The committee recognizes that the narrowness of the projected structural balance necessitates continued attentiveness to maintaining alignment between spending and ongoing revenues. **Therefore, the committee recommends a minimum ending balance of at least $100 million in the general fund for fiscal 2017.**

The committee anticipates that compliance with this minimum fund balance and the spending limit stipulated in Recommendation #1 will result in a cash balance well in excess of the $100 million goal. If this is so, the committee recommends increasing the cash reserves above $100 million and/or dedicating the funds for one-time investments that will:

(1) enhance the long-term financial condition of the State; or

(2) address the State's infrastructure needs while minimizing future debt service costs.

The committee recommends that priority be given to the following prudent investments and that these investments be excluded from the affordability calculation for the 2016 session:

a. Pay-as-you-go (PAYGO) capital for programs and projects statutorily mandated or included in the 2015 five-year *Capital Improvement Program* (CIP). Priority for PAYGO should be given to programs and projects that are not eligible to receive bond proceeds from tax-exempt bonds.

b. Replenishment of the Catastrophic Event Fund. The fund currently has a balance of $132,557.

3. Capital Budget

A. General Obligation Debt

In its 2015 report, the Capital Debt Affordability Committee (CDAC) recommended limiting general obligation (GO) bond authorizations to $995 million each year through fiscal 2025. This is done to slow the growth in debt service costs and provide additional capacity in the out-years.

CDAC's recommendation is advisory and the committee is not bound by the recommendation. In recent years, debt limits recommended by the committee have differed from limits recommended by CDAC. In 2013, CDAC recommended increasing the out-year authorizations by $75 million annually. The committee recommended that out-year authorizations not be increased. In 2014, the committee recommended that the authorizations in the upcoming session's capital budget bill be $75 million less than the level recommended by CDAC in September 2014.

The committee supports CDAC's debt affordability criteria, which limits debt service to 8% of State revenues and debt outstanding to 4% of State personal income. The committee also supports the objective to slow the growth in debt service costs and reduce the debt service to revenue ratio. The committee is concerned, however, that CDAC's recommendation to freeze authorizations through fiscal 2025 will reduce the purchasing power of the capital program. It is estimated that construction inflation at 2% per-annum will diminish the purchasing power by a total of $191 million from fiscal 2017 through 2021.

CDAC's objective can be achieved without substantially eroding the purchasing power of the capital program by increasing the fiscal 2016 authorization, which totaled $1,045 million, by 1% annually. This moderate growth rate limits increases in GO bond authorizations to projected State property tax revenue increases. Since general funds and other State revenues are projected to increase at an annual rate in excess of 1%, this reduces the ratio of debt service to revenues in the out-years.

The committee recommends the authorization of $1,055 million in new GO bonds for the 2016 session. In addition, for planning purposes, out-year annual authorizations should be limited to 1% growth, so that capital spending does not increase at a greater rate than State property tax revenues, which is the primary revenue source supporting debt service.

B. Higher Education Debt

For fiscal 2017, CDAC recommended that the University System of Maryland (USM) issue up to $22.0 million in Academic Revenue Bonds (ARB), which is $10.0 million less than the amount programmed in the 2015 session CIP for fiscal 2017. The decrease results from language added to Chapter 471 of 2015 which increased the authorization by $20.0 million above what was programmed for fiscal 2016, for a total of $54.5 million, to support the funding plan for the New Bioengineering Building at the University of Maryland, College Park. The language stipulated that the additional $20.0 million authorized in fiscal 2016 should be deducted from authorization levels programmed in the 2015 session CIP for fiscal 2017 and 2018 by $10.0 million each year, thereby, keeping the total amount of academic debt authorizations for the five-year CIP planning level consistent with what was programmed in the 2015 session CIP.

Although CDAC's recommendation is consistent with the intent of Chapter 471, the amount of USM academic debt programmed in the 2015 session CIP did not factor in an additional $2.5 million proposed by the budget committees through committee narrative included in the 2014 *Joint Chairmen's Report*. The committee narrative expressed budget committee support to increase the amount of USM academic debt by $2.5 million for each of fiscal 2016 and 2017 to support USM capital projects. While the additional $2.5 million was included in the fiscal 2016 ARB authorization, the 2015 session CIP erroneously omitted the additional $2.5 million recommended for fiscal 2017. As a result, CDAC's recommended fiscal 2017 level is likewise $2.5 million below what the budget committee's proposed in the 2014 session as expressed in adopted committee narrative. **Therefore, the committee recommends that the level of USM academic debt be set at $24.5 million for fiscal 2017.**

4. State Employment

Personnel costs comprise approximately 20% of the State's operating budget. The use of position ceilings and other controls resulted in a decline in the size of the State's regular workforce from 81,113 in fiscal 2002 to 80,839 at the start of fiscal 2016. Declines have been sharpest in Executive Branch agencies, dropping from 55,980 in fiscal 2002 to 50,639 in fiscal 2016. Over 4,100 positions have been added in higher education during this period. As of December 2015, the State has 80,831 positions.

In calendar 2015, there has been a substantial increase in vacant positions and vacancy rates in Executive Branch agencies. The number of vacant positions increased from under 3,900 in January 2015 to over 4,400 in October 2015, which increased the vacancy rate from 7.6% to 8.7%. Most affected are public safety (the vacancy rate increasing from 7.1% to 8.8%) and health and human service agencies (the vacancy rate increasing from 7.5% to 9.3%).

The committee finds that given the State's fiscal condition, 80,831 positions are appropriate for the delivery of State services. The fiscal 2017 budget should not exceed this maximum number of positions across all functions (including the Executive, Legislative, and Judicial branches, and higher education). Agencies should make maximum use of existing vacant positions to address staffing needs. The Governor should use the budget and his authority to abolish and create positions to reallocate personnel resources as necessary to address service needs. Layoffs should be avoided as sufficient opportunities for savings should exist within the existing State workforce authorization.

5. Pension Funding

In response to the investment losses realized during the Great Recession, the State has reformed its pension system to improve the funded status. In fiscal 2008 and 2009, investment losses to the State's pension funds totaled $9 billion. By fiscal 2010, the funded ratio fell to 63%. To improve this ratio, the State took action to improve the funded ratio, including reducing the multiplier for new hires, reducing cost-of-living adjustments for benefits earned after fiscal 2011, increasing member contributions, as well as phasing out the corridor funding method and replacing it with an actuarial funding method. By the end of fiscal 2015, the funded ratio had improved to 69%.

To further improve the funded ratio, supplemental payments, in excess of the actuarially determined amount, have also been made each year since fiscal 2012. In the 2015 session, the legislature provided for a minimum of $75 million in annual supplemental appropriations that are required to be made until the pension fund reaches an 85% funded level on an actuarial basis. At that time, the General Assembly also accelerated by seven years the planned exit from the corridor funding method to an actuarial funding method. This change requires an additional $39 million in State contributions in fiscal 2017. Finally, the legislature passed a statutory "sweeper" provision for fiscal 2017 through 2020 that requires that up to $50 million in supplemental payments be appropriated into the pension fund if there is an unassigned fund balance for the second prior fiscal year. In fiscal 2017, the "sweeper" requires the Administration to appropriate $50 million, in addition to the $75 million in required supplemental appropriations, for a total of $125 million in additional funding beyond the annual employer required contribution.

The actuarial funding method resolves underfunding by amortizing the unfunded liability and fully funding this liability. **The committee confirms that pension funding, like other costs of compensation, is subject to the spending affordability limit. Funds allowed for this purpose pursuant to the statutory requirement to share up to $50 million of unappropriated balance shall not be subject to the limit as it is not paid from current revenue and does not represent a necessarily recurring expense.**

6. The Draft *Consolidated Transportation Program* and Possible Over-commitment of the Transportation Trust Fund are Matters of Concern to the Committee

The committee notes that the draft fiscal 2016 to 2021 *Consolidated Transportation Program* (CTP) reflects a major shift in priorities from those embraced by the General Assembly through enactment of the Transportation Infrastructure Investment Act of 2013 (Chapter 429). The substantial decrease in mass transit capital funding runs counter to one of the major purposes for which transportation revenues were increased in fiscal 2013. Furthermore, overly optimistic assumptions on constraining operational spending within the Maryland Department of Transportation over the next six years combined with questionable revenue assumptions contained in the September 2015 draft forecast make it likely that the Transportation Trust Fund (TTF) is over-committed. **In assembling the final CTP, the Administration should provide an explanation of how projects are incorporated into the CTP, and consider economic impact and reduction of traffic congestion in developing the CTP. Additionally, the final TTF forecast should include operational spending estimates more in line with historic spending levels, continue a revenue reserve as a hedge against revenue underattainment, and reflect revenue for the Watershed Implementation Plan only if spending is included in either the Administration's general fund forecast or the GO bond program.**